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Investing *Fundas* Every Mutual Fund Investor Must Know

As an investor flooded by the complex terms made common through various investment commentaries, you might often feel that there just aren't enough copies of an 'Investment Made Easy Dictionary' on your bookshelf.

So, we thought of curating a handy list of terms that can help you move on your investment learning curve with greater confidence. Here are the five key terms to start with. Watch this space for more.

1. Rupee cost averaging

Simply put, rupee cost averaging is a smart strategy of averaging out costs in a fluctuating market, through systematic monthly investments. Now Net Asset Values (NAVs) of mutual funds fluctuate with the market. The formulaic definition of NAV is that it gives you the per unit intrinsic value of a fund or reflects the value of underlying securities. So, when we make regular monthly investments, we can average out the fluctuations better than if we make lump-sum investments. For instance, suppose you start a Systematic Investment Plan (SIP) of INR 10,000 at an NAV of INR 100. That gives 100 units. If the NAV falls to INR 80 next month, the number of units will increase to 125. Similarly, if the NAV rises to INR 120, the number of units allotted will fall to 83.33. In a falling market, investors get more units, while in a rising market, the value of the investment increases. With the combination of these factors and the fact that you have remained consistently invested, the cost comes down and your overall returns are likely higher than if you made a lump-sum investment.

2. Compounding

This should be easy if you had a good math tutor in school. Suppose someone invested INR 10,000 and earned INR 500 as interest, as part of their SIP. In the next cycle, the return will be calculated at INR 10,500 as the renewed principal. With such additions to the principal over a period of time, the invested corpus grows exponentially. The power of compounding works best for those who start investments early, stay on course with monthly SIPs, and increase the invested amount.

3. Risk-Return Trade-off

A fundamental concept that can help your financial planning - risk-return trade-off is an assessment of the potential risks and returns, and the relationship between the two. The rule of thumb is that the higher the risk, the higher the returns. But additional factors such as time, the nature of your asset allocation and so on can play a defining role in optimizing this trade-off. For instance, the trade-off is different for a large-cap fund from a mid-cap fund or thematic fund. Understanding this concept and pairing it with your asset allocation is crucial for your investment journey. In mutual funds, the risk-return trade-off can be gauged using metrics like Alpha, Beta, Sharpe Ratio, and Standard Deviation. We will know about these terms in the subsequent parts of this series.

4. Diversification

Talking of diversification, one of the things that come to mind is how traditionally mothers would keep money stacked in different places in the house, in a pouch in a hidden corner, another stack for the rainy day hidden in a secret drawer inside the cupboard, while the rest in the bank or locked in some scheme. Diversification is about spreading your money across different kinds of investments so that the probable loss in one investment can be offset by gains in others. The most important role of diversification is managing risk. A diversified portfolio may experience less dramatic swings during market volatility than a more concentrated portfolio. To put it simply, it reflects the oft-quoted phrase – don't put all your eggs in the same basket.

5. **Asset Allocation**

The end goal for investments is to minimize risks and maximize returns. Asset allocation is an essential strategy for diversifying your investments across different asset classes to keep your investment healthy. To continue the health analogy – it wouldn't matter if you ate only fruits. A balanced diet will need the goodness of vegetables, lentils, milk etc. Similarly, for a balanced portfolio, you need a combination of funds that include a mix of asset classes to your portfolio such as equity, fixed income, gold, etc. One of the key concepts behind this is that individual asset classes tend to work differently in different market periods. It is like tending a garden, the spring season brings the choicest of blooms, while some plants grow all year round, while another is well suited to overcome the winter cold.

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